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BEFORE THE ARIZONA CORPORATION COMMISSION

JAMES M. IRVIN
CHAIRMAN
RENZ D. JENNINGS
COMMISSIONER
CARL J. KUNASEK
COMMISSION

IN THE MATTER OF THE COMPETITION IN THE PROVISION OF ELECTRIC SERVICES THROUGHOUT THE STATE OF ARIZONA

DOCKET NO. RE-00000C-94-165

COMMENTS / DISAGREEMENTS
OF PG&E ENERGY SERVICES
On the stranded cost compliance filing of APS
September 21, 1998

BACKGROUND

Commission Decision No. 60977 ordered that "all other parties shall file any comments/disagreements and requests for hearing" within 30 days of each Affected Utility's filing of its implementation plan.

PG&E Energy Services herein submits its comments / disagreements on Arizona Public Service Company's ("APS") plan for stranded cost recovery filed on August 21, 1998. We do not request a hearing, but if one is required, we desire to participate.

SUMMARY OF COMMENTS

APS has submitted a "compliance filing" that is **totally out of compliance** with the Commission's recently adopted policies on stranded cost recovery and generation divestiture as ordered in Decision No. 60977 on June 22, 1998. Energy Services requests that the Commission reject APS' "compliance filing" and order APS not to charge any APS customers taking direct access service from an energy services provider (ESP) any additional charge for stranded costs. We also request the Commission require APS to immediately re-file its unbundled direct access tariffs and fully remove embedded generation costs (a minimum of 3.69 cents per kilowatt hour before "losses" for 1999 as per APS Exhibit 2) and other competitive service costs from regulated unbundled tariffs. Should APS fail to file complying tariffs, we request the Commission itself determine and establish these tariffs before January 1, 1999.

APS rejected this Commission's Option 1, the divestiture of generation assets. Necessarily, therefore, APS must be deemed to have selected Option No. 2 – Transition Revenues Methodology. APS's filing, however, does not conform to Option 2, and either should be rejected outright, or modified by this Commission to conform with the Commission's order. APS's decision not to sell its generation assets must be viewed by the Commission as an economically rational decision. Plainly, in making such an important decision, its management must have carefully considered the potential risks and rewards and performed numerous financial analyses and "what ifs." APS obviously has concluded that retention of its generation has greater value to APS than does divestiture. The Commission provided APS a reasonable opportunity to recover 100% of its stranded costs via a divestiture program plus the Commission allowed for a shareholder incentive payment for sales proceeds above book value. APS has rejected that option. In accordance with Option 2, APS's generation assets must be presumed to have a market value at least equal to their depreciated book value, and therefore APS is deemed to have no generation—related stranded costs. It could easily be the case that APS' generation assets have a value greater than net book and, therefore, the ACC should consider terminating early APS recovery of regulatory assets in order for direct access customers not to be deprived of the stranded benefit of these assets.

In the case of APS, the Commission's course is clear. APS' retail territory should open January 1, 1999 without an additional CTC imposed on customers who elect direct access. The Commission should review this decision based on actual market results after 1999, possibly in tandem with establishing an appropriate unbundled direct access tariff before customer eligibility expands from 20% to 100% in 2001. This Commission should review APS's costs and tariffs carefully since it could very likely be the case that recovery of APS' regulatory assets should terminate prior to full recovery in 2004 in order to enforce compliance with Decision No. 60977.

APS' own estimate of unrecoverable stranded cost for the year 1999 is only $49 million! The estimate for the year 2000 is only slightly greater at $52 million. Even so, both of these estimates are inflated for several reasons including APS' use of artificially low market prices. APS' assumed market price of 2.63 cents per kilowatt hour will not permit Energy Services to compete under any reasonable range of existing market conditions.

APS has very likely made a wise choice for APS, but in so doing it has thumbed its nose at this Commission and erected insurmountable barriers to competition. It should now be apparent APS has **no** remaining stranded generation costs at risk in the market. The Commission's program to accelerate recovery of regulatory assets and APS' own efforts to reduce costs have achieved their intended results. APS forecasts generation costs of only 3.69 cents per kilowatt hour for 1999 in Exhibit 2. We congratulate APS on their low costs! They have reduced their embedded generation costs to levels at which they can retain many existing customers eligible for competition and also remain profitable during their very **first** year of competition.

DETAILED COMMENTS

1. APS' "compliance filing" is totally out of compliance with Decision No. 60977.

A) APS fails to make any reasonable effort to interpret or comply with the Commission's Option No.2 – Transition Revenues Methodology. Any participant to the stranded cost docket knows this option meant that the Commission would provide, **at most**, minimal financial integrity or an allocation of stranded cost to shareholders. APS has not indicated their minimal financial integrity parameters and they have not presented sharing percentages. Decision No. 60977 (page 12, line 25) ordered APS to file "minimum financial ratios to maintain financial viability for ten years." They have not done this – a clear violation of the Order. Perhaps, APS has not provided the information required in Option No. 2 because revealing its present strong financial standing would invite parties to suggest their financial health should first deteriorate to minimal financial parameters before any CTC is established – a very lengthy proposition indeed. Thus, such information would undermine any legitimate claim for a CTC under this option for the foreseeable future. During the period that the Commission has been considering electricity competition, Pinnacle West's (parent of APS) common stock value has increased dramatically.

B) APS includes stranded costs incurred after 1996 (see page 4, line 17) in its Market Generation Credit proposal even though the Commission decided "there does need to be a reasonable cutoff period for stranded costs and the approval date of the Electric Competition Rules is a reasonable cutoff." (page 13, lines 19 and 20.) That cutoff date was December 1996.

C) APS continues to propose a net lost revenues mechanism in spite of the Commission's Fact Finding No. 27 in Order No. 60977: The Net Revenues Lost Methodology proposed by APS provides little incentive for customers to utilize another competitive service.

2. APS' proposed "Market Generation Credit" ("MGC") will completely stifle competition.

A) APS' MGC grossly understates the full costs avoided by APS in not providing retail energy to a direct access customer. Indeed, all APS has done is assigned the pure wholesale commodity cost to the energy credit. Plainly, there is a spread between the wholesale commodity price and the costs of retail energy service and these costs must be recognized in the MGC or APS will have a huge competitive advantage. An ESP must recover in its electricity supply price many costs besides its generation supply costs. These include customer acquisition costs (e.g., marketing and sales), ancillary services, settlements of balancing accounts, metering, billing and collection costs (fully allocated—utilities typically argue these costs should be credited only the basis of the utility's decremental cost of the last bill not sent), contract administration costs, electronic interface costs and DASR processing costs. APS must allocate all of these costs to its energy credit. (This point can be demonstrated through reference to the stranded cost filing of Citizens Utilities also on August 21, 1998. Although that utility passes through (without mark-up) the costs of its purchase power contract with APS to its retail customers in its current prices, it wants a new entrant to take over that same contract and guarantee a six percent price reduction to Citizens customers. How can a new entrant take over a contract that is simply a pass through under current prices and offer a 6 percent reduction? Citizens states a "new entrant would gain a beachhead to the Arizona power market through overnight access to one of Arizona's fastest-growing power markets (Mohave County)." In other words, Citizens understands that a new entrant would lose more than 6% if it wanted to attract customers in their territory under rules that are likely to prevail.)

Of critical importance is that it is insufficient for an ESP simply to offer to a potential customer a break even energy price. Experience has shown that customers will not switch unless they save money—a 10% savings on the delivered price of electricity is a good rule of thumb. This means that an ESP must not only recover all its costs in the price of its electric service—costs that are not reflected in APS's proposed MGC—it must also offer a significantly lower price than the utility in order to induce a customer to switch. The utility, with a 100% captive market (and having already incurred and recovered its acquisition costs), incurs no additional retention costs in keeping its customers if the ESP can't offer the customer savings. These savings are necessary to overcome the inherent advantage of the incumbent utility which already has the customers. Savings are also necessary to help overcome what we sincerely hope are customers misplaced concern that if they switch they will receive a lower quality of *regulated* delivery service from their local distribution utility. Customers repeatedly ask us whether service from the UDC will deteriorate in retaliation for switching. Will outage response times suffer at their sites? Will voltage problems receive prompt resolution? (One only needs to see APS' current TV and print advertising campaign to notice the not so subtle message that (only) APS customers receive reliable power.)

It is safe to say that direct access tariffs will attempt to recover sales, marketing, and other costs that are improperly allocated to non-generation functions. The Commission will need to scrutinize the Affected Utilities' tariffs carefully to ensure that all costs are properly allocated to the appropriate function, that is, the costs that are essential to distribution are allocated to distribution and that costs assignable to competitive activities are excluded from unbundled direct access tariffs.

All of the above points are legitimate issues and solving them does not "game" the system as APS alleges.

B) As many know, a similar type of generation credit is in place in California until at least the first quarter of 2002. Switching to-date in California has been fairly minimal, particularly by residential and small commercial customers. Larger, more sophisticated customers are switching largely because of "CTC financing." Under this approach, an ESP offers power under long term contracts extending several months to a year or longer after the statutory date when the generation-related CTC charge ends. The price is typically a fixed discount in the delivered price of electricity from the tariff rate that would otherwise be applicable for utility service extending over the entire contract term, including the period when CTC recovery has ended. This effectively brings forward for the customer during the initial four years of the contract when the CTC charge is in place some of the benefits of the lower cost of electricity when CTC's have ended. The successful marketing of this type of electricity product in APS's territory is problematic under APS's plan since customers are not likely to lock themselves into 7-8 year power supply contracts because their MGC does not expire until 2005. We must also ask, why does APS need six **more** years to recover its CTC's when its stranded costs, by even APS's calculation, are relatively low?

Fortunately, California has a number of redeeming elements to its restructuring program that helps overcome the shortcomings of that state's generation credit method. These include a substantially reduced return on equity for generation assets (90% of the embedded cost of debt), divestiture of generation assets and several new institutions intended to eliminate the utilities' market power, such as the Independent System Operator and the Power Exchange. All three of these elements are in place in California today, whereas Arizona has not ordered the first, struggles with the second and has virtually canceled one piece of the third (the ISO) before it even got off the ground and not considered the PX. Arizona's divestiture program was intended to overcome these deficiencies. There are many types of potential market power. Please don't be fooled by APS' creative ideas to solve one type of market power if they leave other potential types of market power in tact.

3. **APS has presented a stranded cost forecast for 1999 and 2000 of only $49 million and $52 million, in part, because customer switching is capped at only 20% of the market.**

A) APS stranded costs estimates in Exhibit 2 are only $49 million and $52 million in 1999 and 2000, respectively. It is hard to believe that there has been and continues to be so much attention surrounding an issue that represents less than 3% of APS' revenues in each of the first two years of competition. APS has successfully distracted attention away from legitimate issues needing attention.

B) These estimates are inflated for several reasons. First, it is apparent the Arizona market will get off to a slow start since some key details will not be available until at least December 1997. Second, there will only be a few licensed ESP's in the early months to facilitate switching. Additionally, Arizona has the most costly and time-consuming ESP licensing process of any state with retail competition rules or legislation. We believe this is a primary reason why only one ESP is seeking an Arizona license to supply electricity and over 50 ESP's are seeking licenses in Pennsylvania, yet both markets open January 1, 1999. Third, the Affected Utilities are foot dragging on proposing UDC/ESP service agreements. Fourth, retail market prices are significantly higher than they estimate in Exhibit 2. APS' market can open on January 1, 1999 with no CTC in place and they will not experience $49 million in stranded costs.

4. **APS grossly misrepresents the impact of stranded cost recovery on its distribution business unit (page 11, beginning line 9).**

A) The only reason the Commission has not been able to establish distribution tariffs that fully recover distribution costs, provide an associated return on distribution equity and permit the funding of new distribution infrastructure, is that APS has not yet been willing to file distribution tariffs. No one has even remotely suggested setting distribution tariffs below cost.

B) APS has failed to demonstrate that they face any of the shareholder write-offs they allege (page 12, line16). Regulatory assets are assured recovery by a previous Commission decision. The *asset impairment test* is a very different and much less punitive test than the write-off test for regulatory assets (FASB No. 71). APS has not presented any asset impairment calculations or results.

C) APS' threat of higher interest costs at a time of very low interest rates is ridiculous. Virtually every new bond issuance or refinance must surely be at rates substantially lower than previously. APS has failed to demonstrate that its future interest rates on debt will increase relative to its embedded debt rates. The argument is irrelevant anyway.

In closing, APS' proposal is a major disappointment. APS has failed to comply with Commission Order No. 60977. Its filing should be rejected. APS's filing raises the very serious question of whether APS will take any significant step to encourage the development of a competitive market for electricity supply. It is now abundantly clear that APS has no intention of facilitating meaningful competition; regulatory coercion is necessary. The trust in APS' good faith evidenced by this Commission when it permitted APS early recovery of regulatory assets without requiring APS to undertake any steps to implement competition as a condition to their recovery was clearly misplaced. Unfortunately, it would appear that only punitive measures remain.

Respectfully Submitted, September 21, 1998.

Tom Broderick

Tom Broderick
Regulatory Consultant
PG&E Energy Services
6900 E. Camelback Road, Suite 800
Scottsdale, AZ 85251
(602) 874-4066

An original and ten copies filed today with:

Docket Control
Arizona Corporation Commission
1200 W. Washington Street
Phoenix, AZ 85007

Distribution list for parties that intervened in the Stranded Cost hearing in which Decision No. 60977 was issued.